DOES BOARD COMPOSITION MATTER? AN EVIDENCE FROM SAUDI ARABIA

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Abstract

The study investigates the impact of board of directors' composition on the financial performance of the Saudi listed firms, using models that aim to represent the effect of different board of directors' composition. This paper is focused on dependent, independent and control variables that aim to test further areas that was limited to some previous researchers. It was assumed that there is a negative relationship between the board size and firm performance, as well as female board directors and firm recruiting. However, it was found that both variables have no relationship with firm performance. It was predicted that there is a positive relationship between chair independence and firm performance, as well as a negative relationship in regard to chair independence. Thus, it was established that there is a positive relationship between the non-executive directors and firm performance.

Keywords: Corporate Governance, Board Composition, Firm Performance

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1. INTRODUCTION

Corporate governance has an important and essential role in achieving appropriate balance in the corporation's system. With the help of a balanced corporate system, duties, organizational tasks and goal achievements can be handled effectively. The balanced corporate governance system basically outlines the relationship between stakeholders, management, and the company's board of directors. Thus, the composition of the board of directors plays a pivotal role in the governance of the company. There are a lot of reasons why companies are more aware of its importance. Researchers are interested in various aspects of corporate governance, as its different aspects have a significant impact on financial performance, level of disclosure, etc. (The Fundraising Authority, 2021). Moreover, corporate governance is essential for every marketplace to build trust, as it is important to gain investors' attention and prove that the company is trustworthy by the independence presented in the board of directors. These aspects are crucial for the marketplace as a whole (Guo & Kga, 2012). In Saudi Arabia, corporate laws are developed and modified to keep up with the recent successful and strict rules of the corporate governance framework that in turn raise the enthusiasm of decision makers to adhere to these rules. It leads to the country's better presentation that helps to attract foreign investors. Nevertheless, it elaborates on the firm's accountability (Al-Faryan, 2020). Furthermore, the formation of the board of directors' composition

is one of the main mechanisms of corporate governance. The correct composition of the board of directors must be taken into account, as it has a great impact on various things, such as achieving the strategic goals of the company, influencing the company's activities and success, monitoring and supervising managers, etc. (Guping et al., 2020). Thus, our research questions are:

RQ1: Is there any association between board size and firm performance?

RQ2: Is there any association between non-executive directors and board firm performance?

RQ3: Is there any association between female directors and firm recruiting?

RQ4: What is the association between independence of chair and firm performance?

The study will demonstrate the effects of the independent variables, namely: board size, chair independence, non-executive directors, and female directors. It will also emphasize the effect of a number of control variables, namely: company size, company age and company industry. In addition, the dependent variables that are return on asset (*ROA*) and return on equity (*ROE*) were used as the models for regression analysis. Moreover, this study contributes to filling the gap relating to some of the relationships between the variables with the firm performance. It also contributes to investigating the relationship between the board of directors' composition with the firm performance by having a sample of 50 listed companies from Tadawul (2015–2019).

It is going to be demonstrated starting from the introduction, followed by the literature review and hypotheses development in Section 2, research methodology in Section 3; subsequently, the research results will be demonstrated in Section 4, followed by the discussion of the results in Section 5, finalized by the conclusion reached in Section 6.

2. LITERATURE AND HYPOTHESES DEVELOPMENT

Every country around the world has its own laws and agencies governing its operations. The aim of these laws is unified, however, there are some differences between codes of practices, laws and regulation. As for Saudi Arabia, there are various acts and laws developed and adopted regarding such issues. The first one was created to control the Saudi companies' operations and called "Saudi Companies Act". This act was intended mainly to govern all forms of commercial companies. Moreover, the Saudi Ministry of Commerce put a lot of effort to act out a new law with improved features. The main purpose of such an improvement is to enable Saudi Arabia to contend with the conventional developments in the corporate sectors.

Accordingly, there are several historic changes due to the new companies' act. It was considered a step forward in reforming the corporate sector in the country. That law was the initial bid to handle corporate governance issues. If the law was vague, several codes of governance were intended to fill the gap. Moreover, there are various laws of corporate governance, each dealing with specific issues, such as the establishment of Capital Market Authority (CMA) (Falgi, 2009). Thus, the establishment of CMA was intended to govern and improve the development of the Saudi Arabian capital market. Subsequently, the government established a new committee that was responsible for governing the Saudi stock market. This committee was represented by both Ministry of Finance and the Ministry of Commerce. Later, this committee appointed the capital market responsibility to SAMA, which in turn established a specified unit to accomplish such tasks. This unit was called the "stock control department". It holds the responsibility of regulating the daily stock transactions. At later date, the Saudi stock exchange established Tadawul. As a joint-stock company, it is intended to oversee the daily operations. Then, the Saudi stock market approved itself as one of the distinctive largest markets. Performing a role of an active market in the region of MENA, it had the highest annual turnover in addition to the highest capitalization (Naif & Mohd, 2019).

It is fundamental for each company to have a board of directors that is well-operating and efficient. Having understandable and clearly defined roles and responsibilities helps to achieve the desirable efficient board of directors. The UK combined code states that the task of the board is to include the company's entrepreneurial leadership within a system of prudent and efficient controls that enables risk to be measured and handled. The board should set the strategic priorities of the company, ensure that the company has the required financial and human capital to fulfill its goals, and review the performance of management. Furthermore, there are various sets of roles and responsibilities according to several researchers. However, the general concept of board of directors' responsibilities is to enhance corporate governance through the work of governing and monitoring the company (Falgi, 2009).

Blake (1999) specified the main duties of the board of directors as:

1) administering the strategic operational direction and values;

2) planning acceptance;

3) providing assurance in the matter of organizational capability;

4) obligation to performance observation and controlling.

However, from the point of view of Walker (2010) the board of directors has three fundamental roles:

1) providing strategic advice to increase the shareholder's long-term values;

2) risk management assistance;

3) ensuring that management is responsible for its actions (Falgi, 2009).

Usually, many researchers are attracted by the board size and the extent of its influence on the company. There is an impact on the board of directors' composition and its size, as well as the performance of banks in the area of finance. Studies that deal with corporate dominance and the extent of the influence of the board size, it appears that the board's size is negatively correlated with the financial performance. The size of the board of directors' composition does not correlate positively with the value of the company, because the larger size of the board of directors impedes performance, and the company earns less profit with less efficient use of assets. In addition, some

researchers have concluded that a large number of board members who are restricted to a director is necessary for a good board structure.

As it is fundamental for each company to have a board of directors that is well-operated and efficient, there should be someone who will hold responsibility for the planning and monitoring of the company's operations and strategic objectives. That is why a proper composition of the board of directors should be taken into consideration, since the board composition has a major effect on achievement of strategic goals, aiding the success of the company, overseeing managers closely, etc. Van der Walt and Ingley (2003) stated that "although boards need to represent their ownership and the broader social environment, in creating successful corporate boards, diversity per se is inadequate. The boards of today's firms need to concentrate solely on competence requirements for the selection of directors and, preferably, to include qualified individuals who represent a combination of gender and a variety of qualifications, expertise, and ethnicity. Boards will ought to be mindful of the ability to create meaning by the use of the collected social capital contributed collectively by their directors as a strategic resource for their organization" (p. 232).

There are some factors that are important to keep in mind when it comes to the board of directors and the assistance in raising the efficiency level, namely: both executive and non-executive directors' parity, diversity, board managers integration. Thus, members of the board of directors should differ in gender, personality, education, occupational and functional backgrounds, but, nevertheless, should be integrated (Falgi, 2009).

The governance systems of the industrialized countries have a clear difference in the level of control and ownership. Thus, the corporate governance systems are distinguished by this difference, in addition to the appointment of shareholders who can control the firm. Some systems could be classified as insider or outsider systems. Insider systems are dispersed ownership, whilst outsider systems are concentrated ownership. The conflict of interests in insider corporate governance systems, just like in the United Kingdom and the United States, is mostly between powerful managers and feeble highly scattered shareholders. Controlling shareholders, sometimes called the block-holders, and weak minority shareholders are at odds in outsider corporate governance systems that are prevalent in continental Europe and Japan. Discrepancies in legal, regulatory, and institutional frameworks, as well as cultural norms and historical reasons, are the primary causes of these differences (Aguilera & Jackson, 2003; La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1997).

Based on the importance of corporate governance for sound financial, operational, and market performance, all Saudi listed firms are expected to apply the regulations. As a result, a well-implemented corporate governance structure lowers investor risk, improves investment capital, and enhances business performance (Rezaee, 2009). The effect of corporate governance on firm performance has been widely discussed around the world. Different performance measures, like operational-based measures, market-based measures, and financial-based measures, have been used to investigate the effect of corporate governance on firm performance. Although the most commonly used financial measure is *ROE*, the most commonly used operational measure is *ROA* (Ahmed & Hamdan, 2015). Tobin's Q is the most commonly used market measure in the studies (Kiel & Nicholson, 2003).

Some requirements are needed to ensure that a company has an efficient and balanced board of directors. Firstly, board independence requires that the board has an outside member in its structure, so the best decision can be made during times of disagreement. A further important requirement is a separation between the chairmen and the CEO to avoid the huge problem when one person has too much power and the other carries out both roles (CEO duality). CEO duality led to several historic collapses. Moreover, it is anticipated that the separation between the CEO and the chairman will come up with a major effect on management performance balance because when there is one individual holding so much power, it is more likely that this power will influence the operations. Consequently, it will affect the company's performance. According to the Cadbury report, the separation of duties leads to balanced power and authority and raises the level of board independence (Hashim & Devi, 2008).

Many researchers and company directors believe that the diversity on boards of directors and the development of shareholder value have a positive relationship. In addition, most studies say that demographic diversity has a positive effect on performance, as institutions benefit from diverse boards because it can improve the functionality of the board. A diverse board of directors can integrate a wider range of information to make more informed decisions. Moreover, board diversity helps to create connections with important external stakeholders and indicates a company's commitment to diversity that may help the organization to attract and retain individuals from diverse demographic backgrounds. Diversity encourages a better understanding of an increasingly diverse and complex market. It also promotes creativity and innovation, as well as leads to more effective problem solving by engaging a wider range of perspectives. Finally, diversity generates openness and sensitivity towards other cultures, which facilitates entrenched internationalization. Moreover, when handled properly, diversity can enhance the motivation of human resources and reduce the costs of absenteeism and high minority turnover. On the other hand, there are some downsides associated with greater diversity as they may adhere to board diversity, rapidly initiate the implementation of strategic changes, or lead to board inefficiency. In addition, diversity may lead to increased conflict within the group. A conflict that is negatively related to both the quality of the decision and its emotional acceptance may arise. Diversity can also hinder strategic consensus. Nevertheless, researchers find that there is a positive relationship between functional diversity and interpersonal conflict. Despite some negative effects, diversity has positive

effects on the boards of directors' composition (Fernández-Tem & Tejerina-Gaite, 2020).

Studies increasingly investigate the importance of firm performance with the board of non-executive directors. Thus, the number of non-executive directors on the board is significantly related to the firm performance, which means that the relationship between performance and non-executive directors are effective monitors (Mura, 2007).

The board of directors' composition and the size of the companies have a relationship. Studies have found that the relationship that they have is a negative one, which means that the size of board members does not correlate positively with the value of the company. This is due to the fact that the larger size of the board of directors impedes performance. The company makes less profit with less efficient use of assets (Majeed, Jun, Ziaaa-Ur-Rehman, Mohsin, & Rafiq, 2020).

H1: There is a negative association between the board size and firm performance.

The study investigates the relationship between firm performance and board composition. The number of non-executive directors on the board is significantly and positively related to the firm performance. So, the relationship between performance and non-executive directors is effective monitors (Mura, 2007).

H2: There is a positive association between non-executive directors and firm performance.

Female representation in corporate decision making is an important issue for policymakers. There are increasing pressures for companies from diverse stakeholders, such as the governments, politicians, employer lobby groups, shareholders, etc. (Terjesen, Sealy, & Singh, 2009).

H3: There is a negative association between female directors and firm performance.

The governance practice of corporations of the CEO, chairman, and board composition is a topic that has received a great deal of attention from academics. Studies indicate that there is an important influence and relationship between the independence of the chairman of the board of directors and the composition of the board of directors.

So, the effect is having a positive impact on the performance of the entity (Coles & Hesterly, 2000).

H4: There is a positive association between independence of the chairman and firm performance.

3. RESEARCH METHODOLOGY

In order to conduct this study, data was used and collected from Tadawul, the Saudi stock exchange database, which contained 50 listed non-financial companies out of 272. The sample was selected based on the data availability. The companies' data were selected from the period 2015 to 2019 to measure out the latest trends that affect the corporate governance in Saudi Arabia. None of these 50 listed companies were excluded. The sample was collected randomly using the annual financial statements available at Argaam.com. It contains several listed companies collected from 11 different sectors. Table 1 shows the companies included in the sample by sector in addition to the percentage of the study population compared to the total listed companies in the related sector. However, Table 2 shows the size of the companies included in the population, grouped as per the range of their total assets.

Table 1. Illustration of the companies included in the sample

Sector	*Study population*	*Total observation*	*%*
Energy	3	5	60%
Material	11	42	26%
Capital goods	5	13	38%
Commercial & professional service	2	3	66%
Consumer durables & apparel	4	6	66%
Consumer service	6	10	60%
Food & beverages	7	12	58%
Health care equipment & service	4	7	57%
Pharma, biotech & life science	1	1	100%
Diversified financials	3	3	100%
Telecommunication services	4	4	100%
Total	50	106	

Table 2. Illustration of the companies' size

Number of companies	*Company size range (Total assets) Saudi riyal (SR)*
3	> 50,000,000,000
33	50,000,000,000 < 1,000,000,000
14	< 1,000,000,000

Three control variables were discussed for all estimated models in the study. The control variables are *Company Size* (total assets) as it is a sensitive measure for the company size, and *Firm Age* as it describes the length of years in which a company had been existed or incorporated. In addition to the company industry in which the investigated companies were shown related to their industries.

The methodology of incorporating such control variables was adopted after researching previously published studies in which such control variables were adopted, and a clear result was concluded (Ilaboya & Ohiokha, 2016). As the study intends to investigate the effect of board composition on firm performance, various performance types should be inspected. The *ROE* was used to measure the financial performance of the sample companies. On the other hand, *ROA* was used to measure operational performance. Both measures were used as dependent variables in the study. The methodology of incorporating such dependent variables was adopted after researching previously published studies (Buallay, Hamdan, & Zureigat, 2017). Table 3 shows the variables used to test the sample.

Table 3. Labels, variables and measurements

Labels	*Variables*	*Measurements*
Dependent variables		
ROE	Return on equity: financial performance	Net income divided by total equity (NI/EQ)
ROA	Return on asset: operational performance	Net income divided by average number of total assets for the current and last year
Independent variables		
BODSIZE	Board of directors size	The number of directors on the board
NED	Number of non-executives directors	The number of non-executive directors on the board
FEMALE	Number of female directors	The number of individual females on the board of directors
CH_INDP	Independence of the chairman	Independence of chairman: bladed 1 if the chair is independent, otherwise bladed 0
Control variables		
TASSET	Company size (total assets)	The company total assets
AGE	Company age	The number of years the company has been incorporated
INDUSTRY	Company industry	Each company bladed 1 in the column of its related industry, and 0 in the other columns.

4. RESEARCH RESULTS

The results of the descriptive statistics analysis are presented in Table 4. They are presented for 249 observations. Regarding the board of directors' characteristics, we can observe that the average number of members on the board of directors (*BODSIZE*) is 8.364 which comprised an average of 0.032 female members, in addition to the average of 3.52 non-executives members (*NED*). We can also observe that some companies have an independent board chairman (*CH_INDP*) (22%). In regard to dependent variables, the results show an average of 0.024 of *ROA* and an average of 0.34 of *ROE*. Regarding the control variables, results show that the average length of years a company has been incorporated (*AGE*) is 31.28. The average total asset (*TASSET*) is 15.9 (10^9). Table 5 shows the results of regression analysis using fixed-effect models *ROA* and *ROE* that we applied to 249 observations. Results were carried out at 1%, 5%, 10% significance levels, which means there is a relationship. These models explain the association between the firm performance with these variables, which have the probability of F-statistics that is less than 5%. Therefore, the results for the board directors' composition that affects the firm performance and its relationship with *ROA* and *ROE* should be taken into account. Firstly, independent variables with the base of *ROE* analysis. The board size and the female members in it have no relationship with the firm performance since these two variables are of no importance. However, there is a significant effect at 10% with both chairman independence and non-executive directors, which means there is a relationship between these variables and firm performance. As for the independent variables with the base of *ROA* analysis, the results show that there is no relationship between board size, chairman independence, non-executive directors, and female members. Thus, there is an insignificant relationship between these variables and firm performance.

Buallay et al. (2017) found similar results using *ROE* and *ROA* models. However, when Tobin's Q model was used, the results concerning the association between board size and firm performance were different. The study of Al-Ghamdi and Rhodes (2015) on *ROA* and *ROE* found that board size is significant, but Tobin's Q confirmed that it is insignificant. On the other hand, Coles and Hesterly (2000) stated that there is a relationship between chairman independence and firm performance. Mura (2007) found that there is a positive relationship with firm performance.

Table 4. Descriptive statistics

Variables	*Mean*	*Median*	*Maximum*	*Minimum*	*Std. dev.*	*Skewness*	*Kurtosis*	*Jarque-Bera*	*Probability*	*Observations*
AGE	31.28514	29	112	5	17.28307	1.943663	9.700927	622.6424	0	249
BODSIZE	8.369478	9	13	5	1.379586	0.074248	3.320984	1.297721	0.522641	249
CH_INDP	0.2249	0	1	0	0.418357	1.317795	2.736584	72.78814	0	249
FEMALE	0.032129	0	1	0	0.176697	5.30643	29.1582	8267.671	0	249
NED	3.526104	4	8	0	1.83171	-0.221254	2.228442	8.20782	0.016508	249
ROA	0.030845	0.023436	0.38417	-0.223842	0.078443	0.523041	5.253534	64.04179	0	249
ROE	0.074263	0.057694	3.511316	-0.475038	0.267762	8.609022	110.7949	123630.6	0	249
TASSET (Size)	15.9 (10^9)	1.9 (10^9)	325 (10^9)	63.1 (10^6)	47.4 (10^9)	5	34	11107	0	249

Table 5. Regression analysis using fixed-effects models (models' summary)

Independent variables	*Model 1 (ROA)*	*Model 2 (ROE)*
BODSIZE	0.4952 (-0.002804)	0.4353 (-0.011889)
CH_INDP	0.0675 (-0.025297)	0.1679 (-0.070615)
NED	0.084 (0.006062)	0.4243 (0.010362)
FEMALE	0.8745 (0.004498)	0.1725 (-0.144371)
Control variables		
AGE	0.058 (0.000653)	0.4509 (-0.00096)
CG	0.594 (0.013244)	0.2762 (0.100386)
CCPS	0 (0.152479)	0.0012 (0.383896)
CDA	0.2775 (-0.031379)	0.0001 (0.43211)
CS	0.0395 (0.051123)	0.0075 (0.246701)
DF	0.6484 (0.014139)	0.1513 (0.165236)
ENERGY	0.3282 (0.028998)	0.0793 (0.193391)
FB	0.0304 (0.052959)	0.0253 (0.20299)
HCES	0.0083 (0.070831)	0.0238 (0.224411)
MATERIALS	0.0185 (0.053958)	0.052 (0.164658)
PHPLS	0.4774 (0.02738)	0.4169 (0.11599)
TASSET (Size)	0.9394 (8.09 * (1015))	0.7274 (1.38 * (10^{13}))
SS	0.0045 (0.107033)	0.0681 (0.25365)
R-squared	**0.267218**	**0.135892**
Prob (F-statistic)	**0.000000**	**0.00658**

5. DISCUSSION OF THE RESULTS

To conduct this study, the relationship between board composition and firm performance was inspected. The results indicate that there is no relationship between board size and firm performance, which does not align with the study of. It stated that there is a negative relationship between the board size and firm performance. The results are inconsistent with our hypothesis that there is a negative association between the board size and firm performance. Such a result could be justified by the fact that the individual board member effectiveness and the ability to manage the required tasks do not depend much on the number of other individuals on the board but on the educational and work experience.

Furthermore, the results indicate that there is a negative relationship between chair independence and firm performance, which does not align with the study of Coles and Hesterly (2000). It stated that there is a positive relationship between chairman independence and firm performance. The results are inconsistent with our hypothesis that there is a positive association between independence of the chairman and firm performance. It could be justified that the independent chairman has no financial interest tied to the firm financial performance, so he could focus more on other performance elements that might be costly, and the performance would be reduced.

Moreover, the results show that there is no relationship between female members on the board of directors and the firm performance, which does not align with the study of Terjesen et al. (2009). It stated that there is a negative relationship between female board directors and firm performance. Our hypothesis states that there is a negative association between female directors and firm performance. And it also can be justified that there is increasing pressure for gender diversity and women empowerment. Furthermore, the results show that there is a positive relationship between the non-executive directors (*NED*) and firm performance. The study is consistent with the hypothesis that non-executive directors have a positive relationship with firm performance. The same idea is expressed in the study of Mura (2007). It could also be justified by the fact that non-executives had a financial interest tied to the company performance, so the duties and responsibilities would be effective and profitable.

According to the Saudi Corporate Governance Codes, as is mentioned in Articles 16 and 17, the number of board members shall not be less than 3 or more than 11, and appropriate according to the nature and size of the firm activities. The results show that the average board size is 8.364. On the other hand, the maximum board members number is 13, which is an indicator that there are some firms that do not follow the Saudi Corporate Governance Code. Moreover, there is a specification of non-executive board members in the Saudi Code, as stated in Article 16, that the majority of the board members should be non-executives. The study results show that the average number of non-executive board members is 3.524, however, the maximum number is 8. It means that the companies follow this code (CMA, 2017).

6. CONCLUSION

In conclusion, the study intended to investigate the effect of board composition on firm performance. The obtained results might be developed further, which may lead to more accurate results. The time period involved in the study is extended and divided into three subperiods (early, middle, and late), so the change in variables indicator is more obvious. There are some more variables related to firm performance that may be included to obtain more detailed research. Future researchers may test the variables using models, such as Tobin's Q ratio. Thus, the results can be seen from a wider angle.

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